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APR 3 2001

MEMORANDUM FOR: Sid Saewitz, Team Manager
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LM:RFP:1521

FROM: Matthew J. Fritz, Associate Area Counsel (LMSB)
Cincinnati, Ohio
CC:LMSB:MCT:CIN:2

SUBJECT: [redacted]
EIN: [redacted]
Request for Advisory Opinion Addressing At-Risk Issue

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By a memorandum, you requested assistance in determining whether the taxpayer was at risk within the meaning of I.R.C. § 465 for the tax year ending July 31, [redacted]. In a memorandum dated December 7, 2000, we addressed that issue. Our memorandum was submitted to the National Office for post issuance review. The National Office proposed several changes to our memorandum, as well as wanting us to address other concerns. This memorandum incorporates those changes and addresses the concerns raised by the National Office.

ISSUE

Whether the corporate taxpayer was at risk within the meaning of I.R.C. § 465 for the tax year ending July 31, [redacted] with respect to its investment in a subsidiary.

CONCLUSION

Based on the facts provided, the corporation is subject to the at risk rules. Because the taxpayer has failed to supply the Service with sufficient information concerning its leasing transactions, the amount at risk cannot be calculated.

FACTS

The facts as we understand them follow. In [redacted], [redacted]., began operating the [redacted] as a sole proprietorship. The [redacted] was incorporated on [redacted]. In the late [redacted]'s and early [redacted]'s, [redacted]'s family joined the business. [redacted]'s three children, [redacted], [redacted]., and [redacted], became involved in the business and took over ownership after the death of their father in [redacted].

In [redacted], [redacted] percent of the stock of the [redacted] was transferred to the [redacted] ("[redacted]"). The income beneficiaries of the [redacted] are [redacted] ([redacted] percent), [redacted]. ([redacted] percent), [redacted] ([redacted] percent), the children of [redacted] ([redacted] percent), the children of [redacted]. ([redacted] percent), and [redacted] ([redacted] percent).

The [redacted] owns 100 percent of the stock of [redacted]. ("the Taxpayer"), as well as 100 percent of the stock of [redacted]. ("[redacted]

[redacted]"). The Taxpayer received 100 percent of the shares of the [redacted] from the [redacted] in exchange for its sole share of stock.

The Taxpayer is a full-service company offering the latest in innovative merchandising products and [redacted] ideas for the [redacted] industry, featuring decor and props, as well as case merchandising displays. Each year the Taxpayer publishes the [redacted] for more than [redacted] customers. The [redacted] contains more than [redacted] products. Since [redacted], the Taxpayer has been organized into three divisions: marketing, distribution, and finance/administration. The Taxpayer employs approximately [redacted] employees that include sale representatives, telemarketers, and warehouse employees.

In the tax year ending July 31, [redacted], the Taxpayer was the parent of a consolidated group of corporations that included [redacted] ("[redacted]") and [redacted] ("[redacted]"). [redacted] did not have any employees during the tax year ending July 31, [redacted].

[redacted] ("[redacted]") is a limited liability company that was organized on [redacted], in the state of [redacted]. The [redacted] did not have any employees during the tax year ending July 31, [redacted]. The [redacted] consists of [redacted] membership units. [redacted] made an initial cash contribution to the [redacted] in the amount of $[redacted] membership units. The [redacted] made an initial cash contribution to the [redacted] in the amount of $[redacted] for [redacted] of the [redacted] membership units.

At the close of the tax year ending July 31, [redacted], the balance sheet of the [redacted] indicated that there was debt in the amount of $[redacted]. Of this amount, the amount of $[redacted] was debt originally incurred by the [redacted]. The obligation of this debt belonged to the [redacted] as the notes that were executed contained recourse or partial recourse against the [redacted] or its predecessor. There was no personal guarantee by the individual members of the [redacted]. Section 4.2 of the Operating Agreement of the [redacted] provided that "no members shall be liable as such for the liabilities of the Company." The remaining amount of the debt, or $[redacted], was debt that was incurred by [redacted] in

connection with the purchase of leasing assets. Of this debt, the amount of $[redacted] was recourse debt.

Sometime prior to [redacted], [redacted] assigned and transferred its right, title and interest in and to all leases to [redacted]. On [redacted], [redacted] assigned and transferred its right, title and interest in and to all leases to the [redacted] in a document entitled "[redacted]." [redacted] contributed leasing assets with a cost of $[redacted] and an adjusted basis of $[redacted] to the [redacted]. These assets were subject to debt in the amount of $[redacted] of which $[redacted] was attributable to recourse debt. The Taxpayer reported no income from the transfer because the Taxpayer also transferred cash in the amount of $[redacted] to the [redacted]. The cash transfer was for the remaining balance of the debt. Also on [redacted], this debt was removed from the books of [redacted] and placed on the books of the [redacted]. There was no assignment or negotiation of the underlying promissory notes that had been signed by [redacted]. The promissory notes signed by [redacted] are governed by and interpreted under the laws of the State of [redacted].

In [redacted], the Taxpayer was engaged in leasing section 1245 property through the activities of [redacted], as well as through the equipment leasing activities of the [redacted]. The combined gross receipts of the [redacted] activities of [redacted] and the [redacted] for the taxable year [redacted] were $[redacted].

The Taxpayer filed a consolidated tax return for the [redacted] tax year. On its consolidated income tax return for [redacted], the Taxpayer reported gross receipts in the amount of $[redacted]. The Taxpayer also claimed a deduction in the amount of $[redacted] that resulted from losses related to equipment leasing that was passed-through from the [redacted] via [redacted] on the [redacted] tax return.

In [redacted], the Taxpayer transferred ownership of its subsidiaries to the [redacted] in exchange for 100 percent stock ownership of the [redacted].

ANALYSIS

Congress attempted to limit the use of artificial losses created by deductions from certain leveraged investment activities by enacting I.R.C. § 465 that permits a taxpayer to claim tax losses only to the extent the taxpayer is at economic risk.

I. Application of the At Risk Rules to Closely Held C Corporations

A closely held C corporation is subject to the at risk rules only if it meets the stock ownership test for personal holding company status of I.R.C. § 542(a)(2). I.R.C. § 465(a)(1)(B). Consequently, the at risk rules apply if the corporation has five or fewer individuals that own more than 50 percent by value of the corporation's outstanding stock. See I.R.C. § 544.

Attribution of ownership rules under I.R.C. § 544 apply to determine whether or not the ownership test is met. Under I.R.C. § 544, stock can be attributed to someone other than its owner for purposes of applying the personal holding company stock ownership rules. An individual is deemed to own stock held by or for a corporation, partnership, estate or trust in proportion to his interest in such entity. I.R.C. § 544(a)(1); Treas. Reg. § 1.544-2. In addition, an individual is deemed to own stock owned by or for his family. Under I.R.C. § 544(a)(2), an individual's family is defined to include his spouse, brothers and sisters, ancestors, and lineal descendants.

The stock of the Taxpayer is 100 percent owned by the [redacted] which consists of [redacted], [redacted], the children of [redacted], the children of [redacted], and [redacted]. Under I.R.C. § 544, the beneficiaries are deemed to own the stock of the trust in proportion to their interests. The stock of the Trust would be constructively owned as follows: [redacted] percent, [redacted]. [redacted] percent, [redacted] percent, the children of [redacted] percent, the children of [redacted]. [redacted] percent, and [redacted] percent.

Stock constructively owned by a person by reason of the application of the attribution rules in section 544(a)(1) relating to stock not owned by an individual shall be

considered as actually owned by such person for the purpose of again applying the family attribution rule in section 544(a)(2), in order to make another person the constructive owner of such stock. Treas. Reg. § 1.544-6. [redacted], [redacted], and [redacted] are brothers and sister. After application of the attribution rules under I.R.C. § 544, the stock is constructively held as follows: the [redacted] [redacted] percent[1] and [redacted] [redacted] percent. More than [redacted] percent in value of the Taxpayer's outstanding stock is owned indirectly by [redacted] or fewer individuals, therefore, the taxpayer is subject to the at risk rules unless it qualifies for the special rules for an active business or equipment leasing.

A. Exemption for an Active Business of C Corporation

For purposes of the active business exemption, an affiliated group of corporations that files a consolidated return is treated as a single corporation. I.R.C. § 465(c)(7)(F). Therefore, separate corporate identities of the component members are ignored for purposes of the active business exception.

A "qualifying C corporation" is not subject to the at risk limits for any "qualified business" carried on by the corporation. I.R.C. § 465(c)(7)(A). Each "qualifying business" carried on by a corporation shall be treated as a separate activity. I.R.C. § 465(c)(7)(A).

A "qualifying C corporation" is a closely held corporation that:

(1) Is not a personal holding company, as defined in I.R.C. § 542(a)[2], or

(2) Is not a foreign personal holding company, as defined in I.R.C. § 552(a), or

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[1] Each member of the [redacted] family could be deemed to constructively own [redacted] percent of the stock.

[2] If a corporation is subject to the at risk rules, it will automatically meet the stock ownership test for personal holding company status. Therefore, the corporation must not meet the income requirement for personal holding company status. See I.R.C. § 542(a)(1). Consequently, if a corporation's income is predominantly passive, it will be a personal holding company.

(3) Is not a personal service corporation, as defined in I.R.C. § 269A(b).[3]

A "qualifying business" is any active business[4] conducted by the corporation that meets five conditions:

(1) The corporation must have at least one full-time managerial employee whose services were in the active management of the business during the 12-month period ending on the last day of the taxable year. I.R.C. § 465(c)(7)(C)(i).

(2) The corporation must have at least three full-time non-owner employees whose services were directly related to the business during the 12-month period ending on the last day of the taxable year. I.R.C. § 465(c)(7)(C)(ii). An employee will be considered a non-owner only if he or she owns no more than 5 percent in value of the outstanding stock of the corporation at any time during the tax year, taking into account the constructive ownership rules of I.R.C. § 318.

(3) The corporation's expenses that are deductible only as ordinary and necessary expenses must exceed 15 percent of the corporation's gross income for the tax year.

(4) The business must not involve the use, exploitation, sale, lease, or other disposition of master sound recordings, motion picture films, video tapes or tangible or intangible assets associated with literary, artistic, musical, or similar properties. I.R.C. §§ 465(c)(7)(C)(iv) and 465(c)(7)(E)(ii)(II).

(5) The business must not be one of "equipment leasing," as defined in I.R.C. § 465(c)(6)(B). "Equipment leasing" means the leasing, purchasing,

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[3] I.R.C. § 465(c)(7)(E) provides that status as a "personal service corporation" is tested with a 5 percent threshold for employee-owners, rather than a 10 percent threshold.

[4] When the at risk rules apply, the rules forbid using losses from one activity to offset income from other activities. Therefore, each business of the taxpayer is treated as a separate activity. If the business meets the employee and expense conditions, it will normally be an active business.

servicing, and selling of equipment that is tangible personal property. I.R.C. § 465(c)(6)(B).

The Taxpayer is a qualified C corporation within the meaning of I.R.C. § 465(c)(7)(B) since its income is not predominantly passive. Under I.R.C. § 465(c)(7)(F), the component members of an affiliated group of corporations filing a consolidated return are treated as a single taxpayer. The Taxpayer is a component member of an affiliated group of corporations filing a consolidated tax return. [redacted], a member of the group, engages in the leasing of equipment that is tangible personal property, as well as the purchasing, servicing, and selling of such equipment through the [redacted]. The leasing, purchasing, servicing, and selling of equipment that is tangible personal property is an excluded business under I.R.C. § 465(c)(7)(E)(ii). Therefore, the Taxpayer does not carry on a qualifying business with regard to the business conducted through the [redacted]. Accordingly, losses from that business are subject to I.R.C. § 465(a)(1) unless the Taxpayer qualifies for the special rules for equipment leasing.

B. Exemption for Equipment Leasing by C Corporations

The equipment leasing exemption applies to closely-held corporations that are primarily engaged in equipment leasing, and to separate subsidiaries of the corporations if the equipment leasing is done on a substantial enough scale to justify three full-time employees. For purposes of the equipment leasing exclusion, members of a controlled group of corporations are treated as one corporation. I.R.C. § 465(c)(4)(C).

If a closely held corporation is actively engaged in equipment leasing, the equipment leasing is a separate activity not covered by the at risk rules. I.R.C. § 465(c)(7)(G). A corporation will not be considered to be actively engaged in equipment leasing unless 50 percent of the corporation's gross receipts comes from equipment leasing. I.R.C. § 465(c)(4)(B). "Equipment leasing" means the leasing of equipment that is tangible personal property and the purchasing, servicing and selling of such equipment. I.R.C. § 465(c)(6)(A). Under the statute, the determination of gross receipts attributable to equipment leasing is to be "under regulations prescribed by the Secretary." No such regulations have been issued.

On its consolidated income tax return for [redacted], the Taxpayer reported gross receipts in the amount of $[redacted]. The combined gross receipts attributable to the leasing activities for the taxable year [redacted] were $[redacted]. The amount of the gross receipts from the leasing activities of the Taxpayer is only [redacted] percent of the amount of total gross receipts that was reported by the Taxpayer on its income tax return. Therefore, the Taxpayer is not a corporation actively engaged in equipment leasing under I.R.C. § 465(c)(7)(G).

With the controlled group rule, a closely held corporation would find it very difficult to qualify for the equipment leasing exemption unless equipment leasing was in fact half of the business of the entire group. However, I.R.C. § 465(c)(5) provides that the at risk rules will not apply to the equipment leasing losses of a component member if all of the following conditions are met for the taxable year and preceding two taxable years:

(1) At least 80 percent of the component member's gross receipts come from equipment leasing;

(2) The component member must have at least three full-time employees during the entire year, and substantially all services of these employees must be services directly related to equipment leasing;

(3) The component member must have entered into at least 5 separate equipment leasing transactions during the year; and

(4) The component member must have an aggregate of at least $1 million of gross receipts from equipment leasing during the year.

The Taxpayer does not have an equipment leasing subsidiary that qualifies for the above exception. Although [redacted] percent of [redacted]'s gross receipts in the amount of $[redacted] come from equipment leasing, [redacted] had no employees in the tax year ending July 31, [redacted]. [redacted] did not enter into any equipment leasing transactions during the tax year but rather was assigned two equipment leasing transactions. Consequently, [redacted] only meets two of the four requirements of I.R.C. § 465(c)(5).

Because the Taxpayer does not qualify for the special rules for active businesses or equipment leasing, the Taxpayer is subject to the at risk rules. If a closely held C corporation is subject to the at risk rules, the corporation may claim deductions to the extent that it itself is at risk. I.R.C. § 465(b).

II. Determining Whether Each Activity of the Taxpayer should be treated as a Separate Activity

When the at risk rules are applicable, losses from one activity of the taxpayer may not be used to offset income from other activities of the taxpayer. The at risk rules do not restrict the ability of a taxpayer to offset the loss from one operation against their income from another if the combined operations constitute a single activity for the purposes of the at risk rules. I.R.C. § 465(a)(1).

Generally, activities are not aggregated in application of the at risk rules. I.R.C. § 465(c)(2)(A). If a taxpayer actively participates in the management of a trade or business, then all activities comprising that trade or business are to be aggregated for the purpose of the at risk rules. I.R.C. §§ 465(c)(2)(B)(ii) and 465(c)(3)(B)(i). Section 465 (c)(2)(A) provides that each investment in any of the following types of property will be treated as a separate activity, on a property-by-property basis: a film or video tape; an item of section 1245 property that is leased or held for leasing; a farm; an oil or gas property; and a geothermal property.

Under section 465(c)(2)(A), each separate leasing activity of the [redacted] would be treated as a separate activity. However, section 465(c)(2)(B) provides that a partnership[5] or S corporation that leases or holds for leasing section 1245 property that is all placed in service in a single year must treat the leasing as a single activity.

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[5] I.R.C. § 465 and the accompanying Treasury regulations do not address limited liability companies. For federal income tax purposes, an LLC can be classified as a partnership so long as the LLC lacks at least two of the four corporate characteristics that distinguish a partnership from an association taxable as a corporation. See Rev. Rul. 93-38, I.R.B. 1993-21,4. If the LLC is treated as a partnership for federal income tax purposes, it must comply with section 465(c)(2)(A) .

See Elliston v. Commissioner, 82 T.C. 747 (1984), aff'd, 765 F.2d 1119 (5th Cir. 1985). Prop. Treas. Reg. § 1.465-44(c)(2) provides that if several items are purchased simultaneously, financed as a package, intended to be used together, and leased to one lessee under one lease document, then the items should be considered one piece of equipment and one activity. However, the aggregation rule does not apply to leased equipment that is placed in service in different years.

Section 465(c)(3)(B) provides that certain activities may be treated as one activity if the taxpayer actively participates in the management of the trade or business or the trade or business is carried on by a partnership or S corporation and 65% or more of its losses for the tax year are allocable to person who actively participates in the management of the trade or business. Leasing section 1245 property is not included in the activities that may be treated as one activity under section 465(c)(3)(B). I.R.C. § 465(c)(3)(A)(ii).

In the years at issue the [redacted] assumed two leasing agreements. These lease agreements involved the purchase of section 1245 property that was all placed into service in [redacted]. Each agreement involved the purchase of computer related equipment which was financed as a package, intended to be used together, and leased to one lessee under the respective lease documents. Since this section 1245 property was all placed into service in the year at issue, that leasing would constitute a single activity if the [redacted] is treated as a partnership for federal income tax purposes. If the [redacted] is not treated as a partnership for federal income tax purposes, each separate leasing transaction activity would be treated as a separate activity.

The Taxpayer's business activities involving the food industry have no meaningful relationship with the leasing activity of the [redacted], therefore, the food industry activities and leasing activities cannot be aggregated. Accordingly, losses from the Taxpayer's leasing activities may not be used to offset income from other activities of the Taxpayer.

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[6] The Taxpayer had no business relationship with the [redacted] other than common shareholders.

III. Determining the Amount At Risk

The amount at risk includes money and adjusted basis of property contributed to the activity by a taxpayer. I.R.C. §§ 465(b)(1)(A) and 465(b)(4). If a taxpayer borrows money to use in an activity, the taxpayer will be at risk to the extent he is personally liable for repayment of the borrowed funds, subject to various exceptions mentioned below. I.R.C. §§ 465(b)(1)(B) and 465(b)(2)(A).

When a taxpayer contributes unencumbered property to an activity, the amount which the taxpayer has at risk is increased by the adjusted basis of the contributed property. Prop. Treas. Reg. § 1.456-23(a)(1). When a taxpayer contributes property that is subject only to liabilities for which the taxpayer is liable, the amount which the taxpayer has at risk is increased by the adjusted basis of the contributed property. Prop. Treas. Reg. § 1.456-23(a)(2)(i). If contributed property is subject to liabilities for which the taxpayer is not personally liable, the amount at risk is increased by the adjusted basis in the property and is decreased by the amount of encumbrances to which the property is subject which would not have increased the taxpayer's amount at risk if incurred for use in the activity.

A taxpayer is not at risk for any amount protected against loss through non-recourse financing, guarantees, stop loss agreements or other similar agreements. I.R.C. §§ 465(b)(2) and 465(b)(4). See Segal v. Commissioner, 41 F.3d 1144 (7th Cir. 1994). Borrowed amounts, even if recourse, are not considered at risk with respect to an activity if the lender has an interest in the activity other than as a creditor. I.R.C. § 465(b)(3). A loan will not be included in the borrower's amount at risk if the risk of nonpayment is so sufficiently great that the loan will not be recognized as debt for tax purposes. See Waddell v. Commissioner, 86 T.C. 848 (1986), aff'd on other grounds, 841 F.2d 264 (9th Cir. 1988). To be at risk for borrowed funds, it is not enough that the taxpayer might lose his money, the taxpayer must be the party who is legally required to bear the loss if one occurs. Melvin v. Commissioner, 88 T.C. 63, 75 (1987), aff'd, 894 F.2d 1072 (9th Cir. 1990).

A member of a consolidated group is only considered to be at risk in an activity to the extent that its common parent is at risk in the activity. Temp. Treas. Reg. § 5.1502-45(a)(2). The temporary regulations provide that

the amount that a common parent is considered to be at risk in an activity conducted by a member of its group is the lesser of the amount that the member is at risk in the activity or the amount that the parent is at risk with respect to the member. Temp. Treas. Reg. § 5.1502-45(a)(3).

A member is at risk in an activity to the extent of: its cash contributions to the activity; the adjusted basis of property it contributed to the activity; certain amounts it borrowed for use in the activity, if it is personally liable on the debt or it has pledged property, other than property used in the activity, as security for the debt; and certain nonrecourse borrowing used in a real estate activity. I.R.C. § 465(b)(2).

The common parent is at risk with respect to a member of its group to the extent of: the amount of money and the adjusted basis of property it contributed to the member; borrowed amounts it contributed to the member for which it is personally liable or has pledged property, other than the member's stock, as security for the debt; borrowed amounts that it has guaranteed other than a loan to the member by another member of the group; and any amount it paid to acquire the member's stock from a person other than another member of the group. Temp. Treas. Reg. §§ 4.1502-45(b)(1) and (b)(2). Although the temporary regulations do not address the effect of income earned by a member of the group in determining the amount that the common parent is at risk in that member, such earnings cause a positive adjustment in the basis of the member's stock under Treas. Reg. § 1.1502-32(b)(2) and should be treated for the purposes of the at risk rules as a capital contribution by the common parent to the member and thus an amount at risk with respect to the common parent. The amount the common parent is at risk with respect to a member of its group should also be reduced by intercompany distributions and deductible losses. Treas. Reg. § 1.1502-32(b)(2).

The Taxpayer made an initial contribution to the [redacted] in the amount of $[redacted]. The amount of $[redacted] is at risk.

Despite numerous requests for information pertaining to the taxpayer's leasing activities, the taxpayer has failed to provide the Service with sufficient information from which an accurate computation of the amount at risk in any the taxpayer's leasing activities could be determined.

Information pertaining to all lease transactions is needed to determine the at risk balance at the beginning of the lease, as well as calculate the amounts of recapture income and loss allowance in the years under audit.

If you have any questions, please contact the undersigned at (513) 684-3211.

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Associate Area Counsel
(LMSB)

(signed) GARY R SHULER

By: _____
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